



## Budget Tidbits... just the facts

Senate Republican Caucus

### Budget Brief #12: (10/22/07)

#### **Pension Peril – Disregarding Professional Advice**

*Yet again, the Governor's budget office spearheads rejection of the state actuary's pension funding recommendations.*

#### **A. Actuary's best judgment: \$3 billion more in government contributions needed to adequately fund pension system over next twenty-five years**

The state actuary is charged with making funding recommendations that lead to a sound, stable, and systematic funding of our state's public pensions, a standard required by Supreme Court case law.

State law requires the actuary review the soundness of the long-term economic assumptions (inflation, employment growth, salary growth, and investment returns) used to determine fund values and contribution rates.<sup>1</sup>

After reviewing the assumptions, the state actuary last month recommended a variety of changes, most notably to lower by 0.25 percent the annual inflation and investment rate of return assumptions.<sup>2</sup>

Because pension funding is a combination of employer/employee contributions and the investment return on those contributions, the net impact of the lower assumptions would be to require greater employer (state & local government) funding of our pension system to the tune of \$3 billion over the next 25 years, plus increased employee contributions.<sup>3</sup>

#### **B. State's investment and economic experts supported actuary's recommendation**

The actuary's recommendation was supported by both the State Investment Board and the Economic and Revenue Forecast Council.

The recommendation to lower the rate of return assumption from 8 percent annual return to 7.75 percent was in line with the State Investment Board's own long-term assumptions (which are, in fact, for a 7.6 percent annual return over the next 20 and 50 years).<sup>4</sup>

Additionally, the state's chief economist, Dr. ChangMook Sohn, testified the actuary's recommendation was sound and, if anything, he would lower the inflation assumption, and correspondingly the rate of return assumption, even lower than recommended.<sup>5</sup>

### **C. Despite this, Governor's budget office led effort to reject actuary's recommendation**

Last week the Pension Funding Council, on a motion by the Governor's Budget Director, voted to reject the actuary's recommendation.<sup>6</sup>

***The effect of that decision, as noted earlier, is to over the long run put \$3 billion less in employer contributions into the pension system than what the actuary recommended.***

Why, given the professional consensus supporting the actuary's recommendation, was it rejected?

- One, it makes the short-term budget outlook rosier. Rejecting the recommendation means the Governor's budget office does not have to account for these costs in its six-year budget outlook.
- Two, it appeases union groups that want to hold the line on employee contributions in the immediate future, freeing up greater resources for salary increases and other enhancements.
- Three, to be frank, putting more money into ensuring pension obligations are adequately funded is not a very sexy way to spend money, regardless of how prudent and responsible it is.

### **D. Disturbing trend: Yet another pension recommendation unheeded**

Unfortunately this continues a recent trend of not heeding the actuary's funding recommendations.

Last year, the Pension Funding Council, led by the Governor's Budget Director, rejected the recommendation for additional funding in recognition of longer-life spans. That recommendation would have required an additional \$4 billion in government contributions over 25 years.<sup>7</sup> It remains unacted upon . . . yet the actuary's position has not changed.

In the 2005-07 biennium, the Governor and Legislature rejected the actuary's recommendation to make the scheduled plan 1 unfunded liability payment. Despite a surplus of well over \$1 billion currently, the "skipped" payment has still not been made. Much like a skipped mortgage payment, the long-run costs to taxpayers of not catching up are significant.

### **E. Need to keep politics out of pension funding**

Disregarding the apolitical advice of the state's expert on pension funding is a recipe for trouble, especially when that advice is backed by other investment and economic experts.

***Simply put, the state actuary's recommendations should be treated like that of the state's chief economist who forecasts state revenues. That is, whether the news is good, bad, or indifferent, absent compelling evidence of error, elected officials should heed and accept the results.***

Washington got into pension trouble – and a lawsuit – in the 1970s and `80s by largely disregarding recommendations about pension funding. To this day, taxpayers are still attempting to pay off the short-sighted and ill-advised decisions of that era.<sup>8</sup>

## **Bottom Line**

The state has a contractual obligation to fund its pension system in a sound and systematic manner. A legal question arises, as it did decades ago, whether the state is meeting its obligation when it repeatedly rejects the professional advice of its actuary concerning necessary funding.

For the benefit of all, shouldn't the state actuary's recommendations on pension funding be heeded?

1. *RCW 41.45.030*
2. *"Recommended Economic Assumptions", Office of State Actuary (9/11/07)*
3. *25 year cost projection from 10/11/07 written correspondence by state actuary in response to legislative staff request*
4. *"WSIB Simulated Future Returns", Attachment F (8/31/07) Office of State Actuary Letter to Pension Funding Council (expected annual future returns is 7.62% over 20 years and 7.60% over 50 years)*
5. *Dr. Sohn testimony before Pension Funding Council (9/11/07, TVW audio)*
6. *Pension Funding Council Action (10/17/07), per OFM Director Victor Moore's motion. See also Moore's letter to PFC members on 10/10/07, urging retention of current assumptions and rejection of state actuary's recommendation.*
7. *See Budget Tidbit, "Playing Politics with Pensions" (10/13/06)*
8. *The plan 1 unfunded liability is scheduled to be paid off in 2024.*